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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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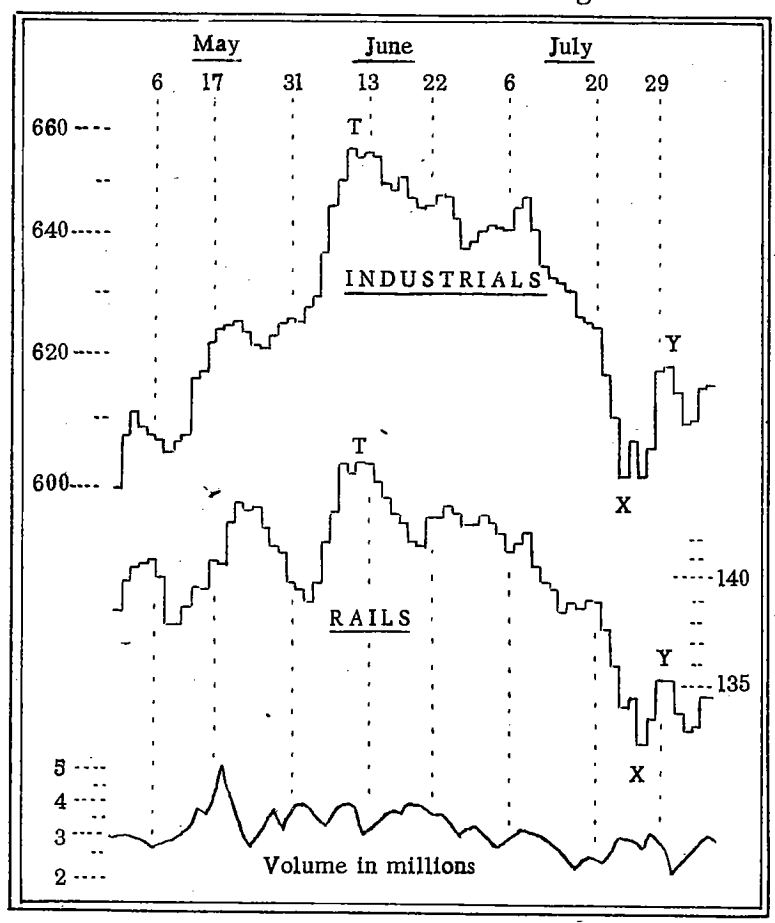
PRICE MOVEMENTS. On July 27 the Rail Average touched a new bear market low of 132.37 (X on chart), following which Rails rallied for two days to record a minor peak at 135.26 (Y). During the same period Industrials formed a minor upward zig-zag (X to Y) and established a peak at 617.85 (Y). Since the Y points, neither price action nor volume has been particularly helpful in suggesting a trend. If both Averages now better the Y points on increasing volume the odds would favor a 1/3 to 2/3 correction of the decline since T (as discussed in Letter 112). This would mean a normal retracement which could take Industrials to the 620-638 area, Rails to the 137-141 area. Conversely, a persistent refusal of one or both Averages to better the Y points could signal the end of the rally and a retesting of the X points.



CONCLUSION. The primary trend is down, the secondary trend is probably down, the minor trend is obscure but will be bullish if the Y points are bettered by both Averages.

A TEST OF VALUES -- Statistics on the Dow Jones Industrial Average:

	Earnings	Dividends	Highest Price	Price-Earnings Ratio	Yield at High
1929	$19.94	$12.75	381.17	19.12	3.1%
1937	11.49	8.75	194.40	16.92	3.7%
1946	13.63	7.50	212.50	15.59	3.2%
1956	33.34	22.99	521.05	15.63	4.8%
1957	36.08	21.61	520.77	14.43	5.2%
1959	34.31	20.74	678.10	19.80	2.9%
1960 (June 30)	32.00	21.21	647.10	19.37	3.3%

(Note: the June 30, 1960, earnings are those estimated by The Trader in Barron's. All yields are computed minus any cash or stock extras.)

The above figures are useful in applying one of Dow's major premises, namely, that "stocks fluctuate together, but prices are controlled in the long run by values". As seen in the table above, the aggregate earnings of the stocks making up the D-J Industrial Average are now below the earnings of the years 1956, 1957 or 1959. Yet as of June 30,

1960, the D-J Industrial Average was selling at a premium of 24.4% above its 1956 or 1957 peak price. Of course the only way that this can occur is in terms of increased optimism and higher price-earnings ratios. Thus, although the $32.00 of earnings for the year ending June 30, 1960, is well below the earnings of the years 1956, 1957 or 1959, the price-earnings ratio for the Industrial Average is now 24% above the 1956 ratio, 30% above the 1957 ratio and only slightly below the record 19.80 ratio of 1959.

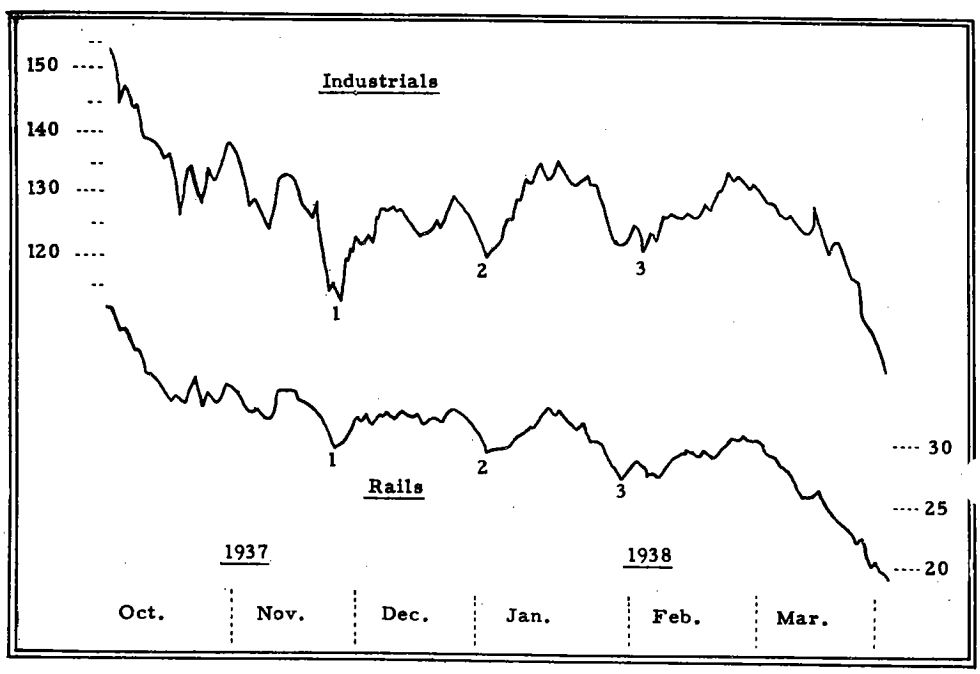
The extent to which the D-J Industrial Average is now overvalued can perhaps best be seen in terms of the year 1929. The current price-earnings ratio is 19.37; in 1929 (at the highs) it was 19.12. This means that despite the steady erosion in stock prices since July, 1959 (the bull market top), stocks as measured by the D-J Industrial Average are still selling above their 1929 peak evaluations!

The D-J Industrials lost 89.2% of their total value in the period following 1929. The correction of the 1932-37 bull market saw Industrials lose 49.1% of their value. During the 1946-47 bear market (one of the mildest on record) Industrials gave back 23.2% of their total value. Only time will tell what percentage of values the current bear market will erase, but based on historical precedent, the eventual correction could be more severe than that which is now envisioned even by the bears.

THEN AND NOW One of the most useful principles of Dow's Theory states that the primary trend is taken to continue in force until proved otherwise. This ostensibly "simple!" thesis has been responsible for saving this writer a good deal of money over the years. Rhea noted that Dow's Theory often resembles a weathervane on a still day; in the absence of a breeze it continues to point in the direction of the last force.

During a secondary reaction one or both Averages may fluctuate for weeks or even months between the secondary extremities and the primary bull or bear points. I have often referred to this area as secondary territory. When the Averages back and fill within such an area for extended periods of time the only thing that can be said with certainty is that investors' nerves will be worn thin. These are the periods when wise men remain silent, market "experts" usually make fools of themselves and amateur "in-and-out" traders do mayhem to their bank balances.

One of the things which today's Dow Theorists can be thankful for is that they have 64 years of the price movements with which to work. (Rhea had the use of only 20 years of price history when he began his studies; Hamilton had only 7.) I have been examining one period of the past which seems to bear a good deal of resemblance to the present one. This is the last quarter of 1937 and the first quarter of 1938. For purposes of comparison I have reproduced a chart which shows the daily closings of the D-J Averages through those six months.



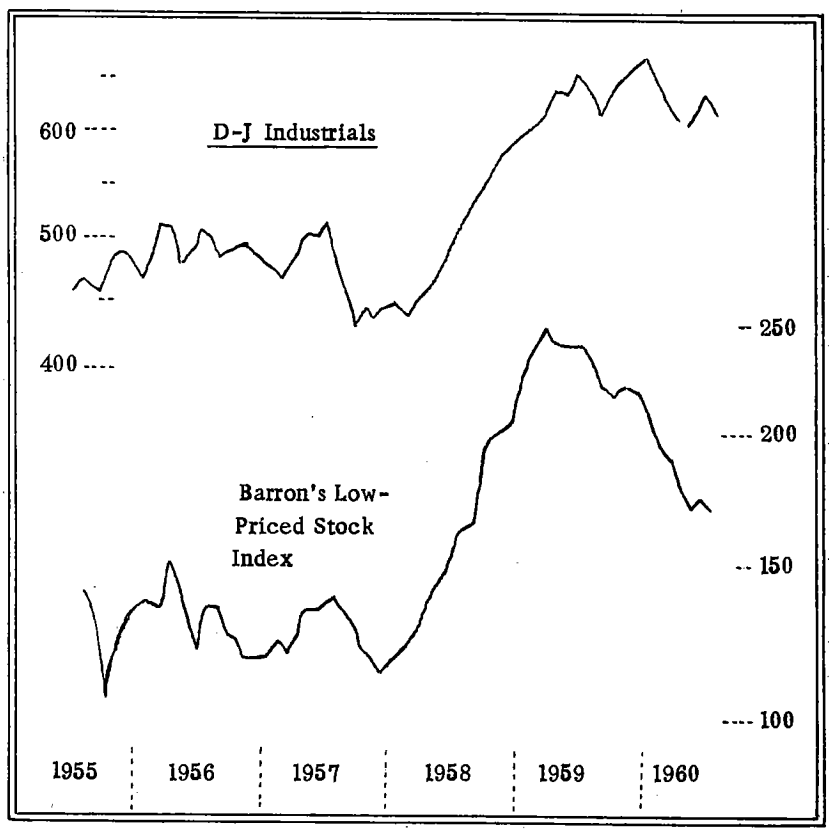
Both Averages touched bear market lows (1 on chart) in November, 1937, whereupon a rally set in which carried the Averages to highs in December. On the next decline (2) the Industrial Average held above its previous low point, but Rails established a new bear

market low. Another rally ensued, and the same pattern was repeated except that here Industrials bettered their previous rally peak. On the retreat to 3 Industrials again held while Rails broke preceding lows. This provided the picture of a "triple bottom" in Industrials with successive new lows in Rails. Following bottom #3, a rally occurred which advanced Industrials almost to their previous peak, but again Rails refused to confirm. When this rally petered out in late February, the subsequent March decline finally established new bear market lows.

I have been asked whether the current picture (March, 1960 to the present) does not resemble a bear market bottom. The answer is that in some ways it does. Many bear market bottoms have formed in areas where one Average persisted in making new lows while the other refused to confirm. But this is not a dogmatic rule; certainly it was not the rule in the 1937-38 period shown on the chart. Moreover, there are other things to consider besides the pattern of the Averages. Three important factors are listed as follows: (1) It would seem strange to me if the excesses of a ten year bull market could be corrected in a single year. Most bear markets last 25% to 50% as long as the preceding bull market. (2) Bear markets generally undergo three recognizable phases. The last phase is usually accompanied by bad news, collapses in "blue-chip" stocks, apathy of the public towards the market and empty boardrooms. (3) At the bottom of a bear market I would expect to see extremely low volume while the market holds against news of the most shocking variety. Generally, volume at a bear market bottom will run about 10% of that seen at the peak of the previous bull market. Obviously, none of the foregoing has been evidenced in the period from March, 1960, to last week.

LOW-PRICED STOCK INDEX (L-P Stocks) The accompanying chart was compiled from figures supplied by Barron's. The chart shows the movements of the D-J Industrial Average superimposed upon Barron's (new revised) L-P Stock Index. Construction of the chart is logarithmic, which means that all price movements are drawn to scale and show the actual percentage of change.

Note that during the 1958-59 third phase of the late bull market, the L-P Stock Index rose a greater percentage than the D-J Industrial Average. This is in keeping with the classic (bull market) third phase "blow off" of the low-priced stocks (last discussed in Letters 95 and 106). Following the 250.68 peak hit by the L-P Index in April, 1959, that Index dropped precipitously (just as it did in the early stages of the 1929-32, 1937-38 and 1946-47 bear markets).



It is also interesting to compare the action of the L-P Index during the 1957 secondary reaction with its more recent action during the bear market. In 1957 the L-P Index did not seem to gain any real downside momentum; it held well above its 1955 low and fell only about as fast (in percentages) as the D-J Industrial Average. But since April, 1959, the L-P Index has dropped sharply, and the drop has been much greater in percentages than (a) the 1957 decline in the L-P Index, or (b) the 1959-60 decline in the D-J Industrial Average.

It is a normal occurrence for the L-P Stock Index to slump in the early stages of a bear market. In contrast, many of the worst collapses in the "blue-chips" have appeared in the later stages of a bear market (in the third or final phase).

Two weeks ago Barron's L-P Stock Index registered a new low of 169.8. This means that the Index has lost 32% of its total value in the first year of the bear market. (Note: for a list of stocks which make up Barron's L-P Index see Barron's -- July 18, 1960).

GOLD In the Letter of March 15, 1960, I suggested the purchase of gold stocks. Because of the recent sharp flight of gold from this country, interest in the gold shares is being revived. The theory behind the purchase of gold stocks is twofold. (1) Gold is one of the few commodities which will hold its price during a severe economic contraction. Since the price of gold remains stable and wages and production cost tend to go down in a recession, the profits of gold mining companies will rise. (2) There is the possibility that the price of gold will be increased as an incentive to production and as a spur to bring gold back to the country. Although the gold price rise may not materialize, the rumor is often as good as the accomplished fact.

British Treasury bills are now priced to yield around 5 1/2% against our own Treasury bills which yield 2.2%. Moreover, other European countries offer investors attractive situations which yield 6-8%. The incentive for International "smart money" to leave our shores is strong. Foreign dollars in this country have a constant call on our gold, and in most cases when foreign money leaves here our Government must sell gold to cover the departing dollars.

Three things could turn the present disturbing loss of gold into a rout: (1) A return to mass deficit spending (and inflation). To get us out of the 1957-58 recession, for instance, our Government ran up a 12 billion dollar deficit. If this inflationary process is repeated, the consequence in terms of foreign gold withdrawals could be disastrous. (2) An attempt by an administration to take over the Federal Reserve Board, which is the present bulwark of the "sound dollar." If foreigners even suspected that the Fed was to be turned into a political inflation machine they would withdraw their gold. (3) A worsening of the balance of international payments. This means that we must either become competitive with other countries or face the prospect of America's buying foreign goods with dollars (and losing gold) while foreigners resist buying our goods (and thus do not return the gold).

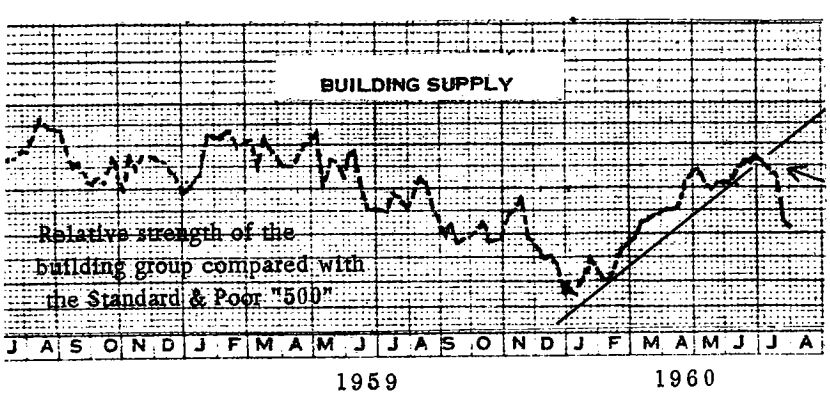
I have talked with experts who say that gold is a good "play" and that its price must be raised; I have heard other experts cite good reasons why the price of gold will not be raised. It does seem to me, however, that in view of the technical action of the gold stocks, the group now represents an intelligent speculation.

In their book "Making the Dow Theory Work", Fritz and Shumate note that "over the period held, they (the gold stocks) showed a net profit of 21% while the Industrial Average declined 11% and the Rail Average 27%" (page 63). Recently Mr. Shumate wrote me as follows: "I suspect that the best spot in which to pick them up (gold stocks) is the nearest approximation one can make to the final downthrust of a primary leg." In other words, it is during bear market reactions (upward) that the golds usually make their big moves.

Following this line of reasoning, the best place to buy golds would seem to be the bottom of any extended decline which might be signalled by the Industrial Average's violating 599.10. Stocks and groups do not always act identically in every bull or bear market, and the above information is offered in the light of past history. If a play on the golds is desired, however, part-purchase might be made in the current area with the remainder of the commitment completed on any extended downward leg. Homestake, Campbell and Dome represent a good cross-section of the gold stocks and should be expected to participate in any movement of the group.

STOCKS. Despite the talk of a forthcoming upturn in building, the building stocks are beginning to look weak. Bestwall and U. S. Gypsum can be sold short at the market. Flintkote is a short at a closing of 33 or below, Georgia-Pacific is a short at a close of 53 or below.

(Written Tuesday, August 9, 1 P. M.)


BUILDING SUPPLY
Relative strength of the building group compared with the Standard & Poor "500"
J A S O N D J F M A M J J A S O N D J F M A M J J A
1959
1960

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